

# Salem Partners – Aerospace & Defense

## Quarterly Review

## Introduction

Second Quarter 2011

Dear Friends,

We are proud to announce that Salem Partners advised KaZaK Composites on its sale to Israel-based Plasan. We initiated a highly targeted marketing process that focused on strategic partners with significant participation by international buyers including the successful navigation of the CFIUS and ITAR approval processes.

In capital market news, we have seen the pace of M&A activity stay consistent with Q1 2011 levels as both strategic and financial buyers remain active but below the pace of the 2<sup>nd</sup> half of 2010. In particular, we have seen private equity buyers aggressively pursuing transactions as pressure to deploy capital remains a key impetus for deal flow.

Over the last quarter, the entire A&D industry had cause to celebrate as the death of Osama bin Laden highlighted nearly a decade of persistent, perilous efforts by our US military. Over that time period, we have witnessed a massive investment and subsequent transformation in the way our nation responds to, and combats, a wide range of ever-evolving threats. While the death of bin Laden has been celebrated as a successful delivery of justice, many critics of the defense industry are using the event to push for more aggressive troop withdrawal timelines and reductions in the DoD budget. In conjunction, President Obama announced his intent to withdraw 10,000 troops from Afghanistan by the end of 2011, and a further 23,000 by the summer of 2012. A growing perception that the wars in Afghanistan and Iraq are complete, combined with daily headlines on the US deficit are serving to amplify the reoccurring theme of pending defense spending cuts.

For commercial aerospace, the key news event during the second quarter was the activity at the biennial Paris Airshow, and the flurry of new orders centered around Airbus' A320NEO model. A large volume of new orders were driven by increasing concerns over rising jet fuel prices, the need for North American and Western European fleet rejuvenation and a rapidly-growing Asian and Latin American commercial air traffic market. The show also suggested that increasing competition for market share in the narrowbody segment is on the horizon, as dominating incumbents Airbus and Boeing are challenged by Bombardier, Comac and potentially Embraer.

Please enjoy the remainder of our industry review and, as always, we welcome your comments and questions.

Sincerely,



Trevor Bohn  
Managing Director



Sean Walker  
Managing Director



## HIGHLIGHTS

### ❖ KaZaK Acquisition

## M&A – Plasan Acquires KaZaK Composites



### **About KaZaK Composites**

KaZaK is a privately held, Massachusetts-based company that specializes in high performance composite engineering and manufacturing for application in military defense markets, including UAV's, ground vehicles and combat ships. With 26 degreed engineers, KaZaK offers innovative composites solutions to a range of defense customers including General Dynamics, Raytheon and Boeing. The business was founded in 1992 by Dr. Jerry Fanucci.

### **About Plasan**

Plasan Sasa is a private, Israeli company providing customized, lightweight survivability solutions for tactical combat vehicles, fixed and rotary winged aircraft, naval platforms, civilian armor vehicles and personal protection.

### **Salem's Role**

Salem Partners acted as the exclusive investment banking advisor for KaZaK Composites. After developing a relationship for several years with the owners of KaZaK, Salem recommended initiating a targeted marketing process to take advantage of the strong market demand for middle-market A&D businesses as well as to capitalize on the dramatic growth that the Company had experienced. Salem worked closely with management to effectively position KaZaK for a positive reception from the market. After navigating a targeted marketing process that focused on international strategic buyers, KaZaK selected Plasan as its ideal partner. Salem navigated the rigorous process of receiving approval from the federal government (CFIUS and ITAR) and negotiated a premium valuation for the business.

# Capital Markets

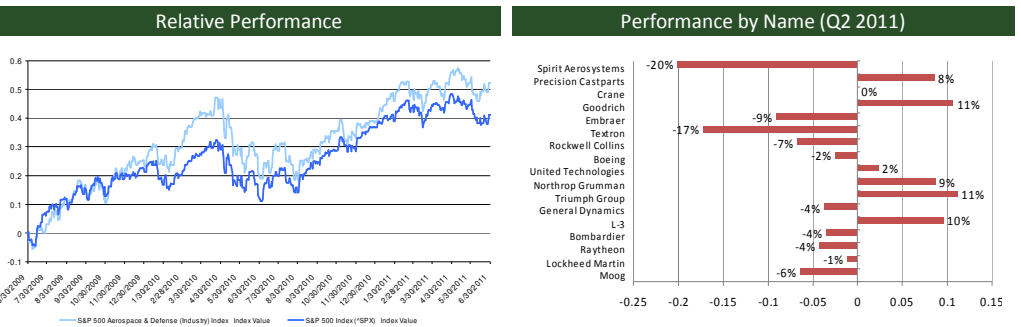
## HIGHLIGHTS

### Capital Markets Commentary

#### Capital Markets

The second quarter of 2011 saw mixed performance among aerospace and defense companies. Spirit Aerosystems and Textron were hard hit after missing earnings estimates, Spirit citing a \$28 million pre-tax charge associated with its Sikorsky CH-53K contract as a drag on its performance, while Textron pointed to low production and delivery levels in its Cessna division for its operating loss. Goodrich, Triumph and L-3 showed positive performance, gaining 11%, 11% and 10% on the quarter, respectively.

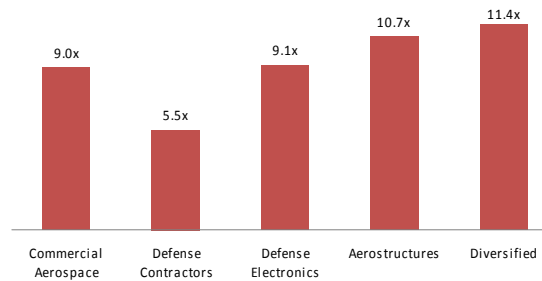
The S&P Aerospace & Defense Index remained flat for the second quarter of 2011, while the S&P 500 Index fell 2.2% over the same period.



Source: Analyst Research

Source: Analyst Research

#### Enterprise Value/EBITDA by Subsector



Source: Analyst Research

### A&D M&A Activity

#### A&D M&A Activity

Date	Target	Acquirer	Enterprise Value	Multiples	
				EV/ Rev	EV/ EBITDA
10-Jul-11	Primus International, Inc.	Precision Castparts Corp. (NYSE:PCP)	\$900	-	-
28-Jun-11	KaZak Composites, Inc.	Plasan Sasa Ltd.	-	-	-
22-Jun-11	Disan Engineering Corporation	Cherokee Nation Businesses, LLC	-	-	-
22-Jun-11	CMA Cover Corp.	Admiralty Partners, Inc.	-	-	-
16-Jun-11	Premier Aviation (UK) Ltd.	Hunt & Palmer Plc	-	-	-
15-Jun-11	Health Teena, Inc.	Zodiac Aerospace SA (ENX:PAZC)	-	-	-
14-Jun-11	GE Aviation (Tru-Form business unit)	Precision Castparts Corp. (NYSE:PCP)	-	-	-
13-Jun-11	Russell Plastics Technology Co., Inc.	H.I.G. Capital	-	-	-
7-Jun-11	Quality Forming, Inc.	Platte River Ventures	-	-	-
24-May-11	BAE Systems Composite Structures Inc.	EnCore Composites Holdings, Inc.	\$33	-	-
19-May-11	Nantucket Shuttle, Inc.	Island Airlines, LLC	-	-	-
10-May-11	Alakai Technologies Corporation	Guardian Mobility Corporation	-	-	-
5-May-11	PB Fasteners (assets)	Precision Castparts Corp. (NYSE:PCP)	-	-	-
29-Apr-11	City Airline AB	Skyways Holding AB	-	-	-
20-Apr-11	Detection Systems operations and certain related assets	Chemring Group plc (LSE:CHG)	90	1.5x	-
18-Apr-11	Crossman Corporation	Wellspring Capital Management LLC	-	-	-
12-Apr-11	Helicopters NZ Ltd.	Canadian Helicopters Limited	125	1.9x	5.7x
7-Apr-11	Aero Quality Sales	Satair AS (CPSE:SAI)	30	-	-
6-Apr-11	Nobles Manufacturing, Inc.	Inverness Graham Investments	-	-	-
5-Apr-11	Emivest Aerospace Corporation (assets)	Metalcraft Technologies, Inc.	5	-	-
5-Apr-11	General Dynamics Armament And Technical Products	Skyways Holding AB	-	-	-
5-Apr-11	AML Communications Inc. (OTCPK:AMLJ)	Microsemi Corp. (NasdaqGS:MSCC)	23	1.5x	8.7x

(\$ in million)

Source: Analyst Research & Salem Partners estimates

## HIGHLIGHTS

### ❖ Paris Air Show

### ❖ Airbus and Boeing

# Industry Headlines - Aerospace

## Paris Airshow Recap

The June 20<sup>th</sup>-26<sup>th</sup> Paris Airshow saw an abundance of orders for new aircraft, suggesting a continued recovery for the commercial airline industry despite rising fuel costs and the remnants of the global recession. Supported by global airline traffic of 6.8% over 2010, the improving health of the industry has encouraged operators to make the investments in fleet additions that were previously on hiatus until global economic . Going into the show, the broad commercial aerospace industry was riding a wave of momentum as rate hikes on a range of platforms have given the industry a great multi-year outlook. Investors were looking to the show to provide an additional spark by the announcement of several splashy orders (especially American Airlines).

## Airbus Receives Lion's Share of Paris Airshow Orders

Airbus led the way among manufacturers in the ordering frenzy, tallying a record 734 orders from various customers, including an order from AirAsia for 200 aircraft. Most Airbus orders were for the A320NEO, the more fuel-efficient narrowbody offering in Airbus' lineup, as operators look to recover margins lost due to rising fuel prices. The recent release of the A320NEO, combined with held orders in anticipation of the airshow, resulted in an impressive, yet not surprising, total of 667 orders for the model. The excitement generated from the ordering volume was tempered for Airbus by the announcement of delays in two of its other aircraft models, including its widebody A350-1000, which will be delayed until 2017 due to continuing engine development.

With the absence of its own new narrowbody offering, Boeing's total order count for the show was modest by comparison at just over 100. Orders for Boeing included four 747-8 freighters by GE Capital Aviation Services, the first commitment from GECAS for the model, and six 777 aircraft from Qatar Airways.

On July 20<sup>th</sup>, American Airlines announced its decision to split a massive narrowbody order between Boeing and Airbus. Traditionally a Boeing account, the AMR decision was a surprise to investors and provides further indication of the growing acceptance of the A320NEO.

Paris Airshow 2011 Orders – Airbus and Boeing		
Company	Airbus Model	Boeing Model
Air Lease	44 A320neo/A321/A330	29 737/777/787
AirAsia	200 A320neo	
ALAFCO	36 A320neo/A350XWB	
Avianca Taca	51 A320/A320neo	
CIT Leasing	50 A320neo	
Garuda Indonesia	25 A320/A320neo	
GECAS	60 A320neo	10 777/747-8F
GoAir	72 A320neo	
JetBlue	40 A320neo	
LAN Airlines	20 A320neo	
Norwegian Air Shuttle		15 737
Republic Airways	80 A319neo/A320neo	
SAS	30 A320neo	
Saudi Arabian Airlines	4 A330	
Skymark Airlines	4 A380	
TransAsia Airways	6 A321neo	
Utair Aviation		40 737
Other	10 A380	17 747-8i
<b>Total</b>	<b>732</b>	<b>111</b>

Source: Analyst Research, company information and RBC Capital

## HIGHLIGHTS

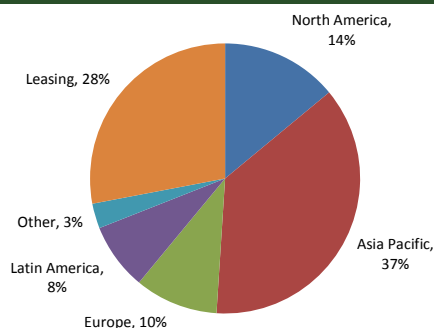
### ❖ Regional Drivers

# Paris Airshow – Recap (continued)

## Sources of Growth

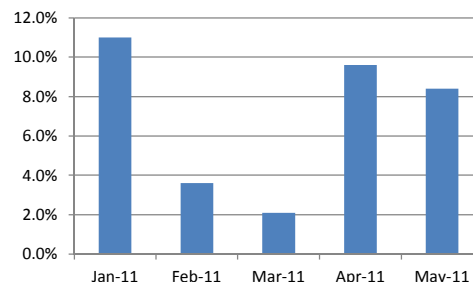
The desire for increased fuel efficiency wasn't the only factor contributing to the large volume of orders placed at the Paris Airshow. Despite uncertainty over ongoing Middle Eastern conflicts and the repercussions of recent Japanese natural disasters, global demand for new aircraft is on the rise. North American and Western European operators have put off rejuvenating their aging fleets with new aircraft, and are now beginning to make necessary investments. Meanwhile, Asian and Latin American operators have seen year over year airline traffic revenue increase every month since July of 2009, and continue to make fleet additions to address regional growth. The Airshow again saw ordering activity dominated by the Asia Pacific region with lessors also continuing their resurgence to make up 28% of total orders.

Airbus and Boeing Paris Airshow Order Distribution



Source: Company reports and RBC Capital

Asian Airlines' YTD Traffic Growth (YoY RPM)



Source: Company reports and RBC Capital

### ❖ Narrowbody Players

## New Players in the Narrowbody Space

The Paris Airshow also saw the further development of competition in the 100-200 seat narrowbody market. While traditional Airbus and Boeing dominance of the largest commercial aircraft segment held strong, Canada's Bombardier made a significant breakthrough with an LOI for 10 of its CSeries aircraft, and an option for 10 additional CS300 aircraft, from Korea Air Lines Co., its first Asian customer. The estimated entry of Commercial Aircraft Corp of China Ltd.'s Comac C919 narrowbody aircraft in 2016 and a potential narrowbody offering in development from Embraer SA suggest that heated competition in the space is not far off the horizon, and Airbus' and Boeing's dominance will be put to the test.

## Powering the Next Generation of Narrowbody Aircraft

### ❖ Narrowbody Engines

The large volume of narrowbody orders at the Paris Airshow also carried implications for the engine markets that power them. CFM International's LEAP-X engine held off competitor Pratt & Whitney's GTF model on its way to claiming 63%<sup>1</sup> of the new narrowbody orders in which engines have been selected. CFM looks to remain the exclusive provider to Boeing's 737, as well as a potentially re-engined 737 offering, and is reportedly developing a smaller version of the LEAP-X that will provide increased fuel efficiency over the current Boeing 737NG.

<sup>1</sup>Source: JP Morgan equity research

## HIGHLIGHTS

### ❖ *Afghan Drawdown*

# Industry Headlines - Defense

## Afghan Drawdown

On June 22, 2011, President Obama announced a troop reduction in Afghanistan that is expected to bring home approximately 10,000 United States soldiers. News of the reduction was much anticipated, however, the number, steeper than military and Pentagon officials expected, came with some scrutiny. Fear of prematurely withdrawing American troops from the Middle East was prominent among Pentagon and military officials who do not want to lose control of an unstable Afghan region. This position is contrasted with the fact that President Obama is facing mounting pressure from Congress to honor his original 2009 plan for troop reduction as well as to curtail military spending.

Obama's original strategy called for an initial surge of 30,000 troops, followed by a gradual reduction of approximately 100,000 troops stationed in the Middle East to be completed by 2012-2013. With the recent news of a 10,000 troop reduction, as well as future planned withdrawals, a total of 33,000 troops will return to the U.S. by next summer. While this news is welcomed by many administrators and congressional members who point to the \$10 billion per month cost of supporting 100,000 troops as a large contributor to our rising deficit, the same level of elation is not shared by Pentagon and military officials who would have preferred a reduction rate around 4,000 rather than planned 10,000.

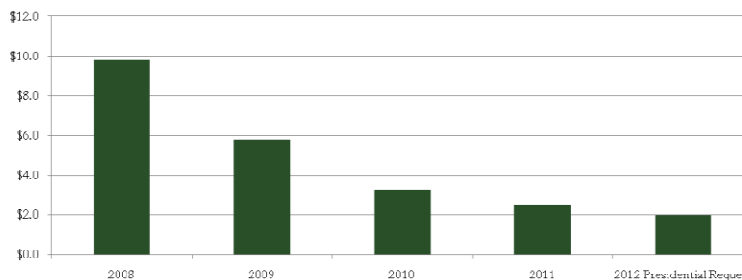
The pending troop drawdown is sure to have a material effect on the defense spending and its stakeholders. Over the past two years, the effect of the Iraqi withdrawal on defense industry participants has been mitigated by increased troop deployment in Afghanistan. Now with Obama's plan in motion, the United States will not have a material presence in the Middle East for the first time in ten years.

## Ground Vehicle Spending

### ❖ *Ground Vehicle Spending*

As we have mentioned in previous industry reviews, one area of the defense industry that is particularly vulnerable to budget cuts is ground vehicles. After the introduction of IED's into the war in Iraq, a new focus on modernizing the ground vehicle fleet began with the development of a variety of programs, particularly the MRAP and M-ATV. Significant investment and procurement dollars were spent to provide safer troop transport and logistics services. Over the past seven years, the DoD has spent more money on ground vehicles than on any other program. Unfortunately, it is our view that this trend is unlikely to continue as ground vehicles spending is most directly correlated to operating tempo. Even with production volumes for current generation models already declining, it appears that next-generation systems like the JLTV and GCV are unlikely to receive the necessary funding to finish RDT&E and enter full rate production. The ground vehicle market is likely to be the first casualty in a declining budgetary environment.

Ground Vehicle Funding (\$ billions)



Source: RBC Capital

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